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Dream house no more

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The hangover from the rich countries' housing bust is likely to depress growth and keep unemployment high in 2011 – and for much of the next decade. But the dream of homeownership is very much alive – and is a powerful economic force – in the emerging world.

The financial crisis that began in 2007 had its roots in excesses in the housing market that remained unresolved in 2010 – and that will continue to roil economies in 2011 and beyond. Everybody now knows about America's dodgy 'subprime' mortgages (the term says it all). But it is all too easy to forget that the development of this market was initially welcomed, because it enabled even people who would not normally qualify for a mortgage loan to aspire to homeownership. Subprime mortgages made the American dream come true.

Of course, billions of others around the world share the same dream. But the way housing finance is organised differs enormously from country to country, and these differences explain the recent global imbalances and financial crashes.

In developed economies, construction can add only a relatively small amount each year to the existing stock of housing. With populations stagnating (or declining in many parts of Europe and Japan), the existing stock of housing is exchanged among different parts of the population, and typically bequeathed from old to young.

The situation is different in emerging economies, where the quantity and quality of the existing stock of housing are woefully inadequate. Moreover, most of the existing housing tends to be in rural areas, whereas most of the jobs are in the cities. This is why urbanisation means a huge building boom in emerging economies. China, as usual, is the most extreme example, now accounting for more than one-half of global cement consumption.

The dream of homeownership is thus very much alive – and is a powerful economic force – in the emerging world. But mortgage markets remain underdeveloped in most emerging economies. This means that young Chinese couples will first have to save a large part of their income as a down payment for their dream house (typically an apartment in a high-rise). The absence of 'no money down' mortgages might be more important than Confucian ethics in explaining China's high savings rate. One sure way to reduce the savings rate in China would be to develop an American-style mortgage market there.

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The Chinese and others should, however, bear in mind that an increase in housing prices does not make a country richer. Of course, every homeowner will *feel* richer if his property's price goes up. But if the price of all housing goes up, the country as a whole is no better off; after all, people have to live somewhere, so, other things being equal, cashing in on higher house prices would merely mean paying more for one's next home. Housing booms thus create only an illusion of wealth, though it is compelling enough to induce excessive consumption, as occurred in the United States over the last decade.

Conversely, a crash in house prices does not destroy any real wealth (the houses still stand). On the contrary, a crash makes the dream of ownership more affordable, which benefits first-time buyers – typically the young and less well-off.

But, from an economic point of view, the share of homeowners versus tenants is not very important. If the rental market is well developed (as in, say, Germany), most families might elect not to own. But Germans still own indirectly the houses they live in through their investments with life-insurance companies and savings societies, which own and manage a large proportion of the country's housing estates.

By contrast, from an economic point of view, many American households really rent their homes from the Chinese government. They might be proud homeowners on paper, but their mortgage was probably underwritten by quasi-governmental institutions like Fannie Mae and Freddie Mac, which in turn rely heavily on capital from China for their own refinancing.

The real danger arises when everyone is convinced that investing in real estate is the best way to secure one's own future because house prices can only go up. This induces lenders to provide not only NINJA (no income, no job, no assets) mortgages, but also generous loans to real-estate developers to build ever-larger mansions and housing communities.

As long as a boom lasts, everybody benefits. But when the bubble bursts, the NINJAs cannot service their debt and builders go into bankruptcy. Lenders find that the collateral (half-finished or empty houses) is worth almost nothing, resulting in huge losses in the banking system (as the US found out in 2008). In extreme cases, as in Ireland (one hopes not in Spain), the need to save the banking system can bankrupt an entire country.

Housing booms can last a long time, typically more than a decade. The downside is that housing busts last equally long, because houses are such a durable good. Once too many houses have been built, the existing overhang depresses the market for a very long time, and unemployed construction workers are usually unable to find jobs elsewhere.

The last decade saw the peak of an unprecedented housing boom in most of the rich world. The bust, with its banking problems and unemployment, is likely to last for most of the coming decade, depressing growth in all those countries that looked so strong in 2008.

By contrast, the emerging economies have barely started their own boom, which is underpinned by the spillover of liquidity from the US. The emerging world's boom might well stretch over the entire next decade, as hundreds of millions of homes are built. The next bust can be avoided only if emerging markets manage the dream of homeownership better than the US and Europe.